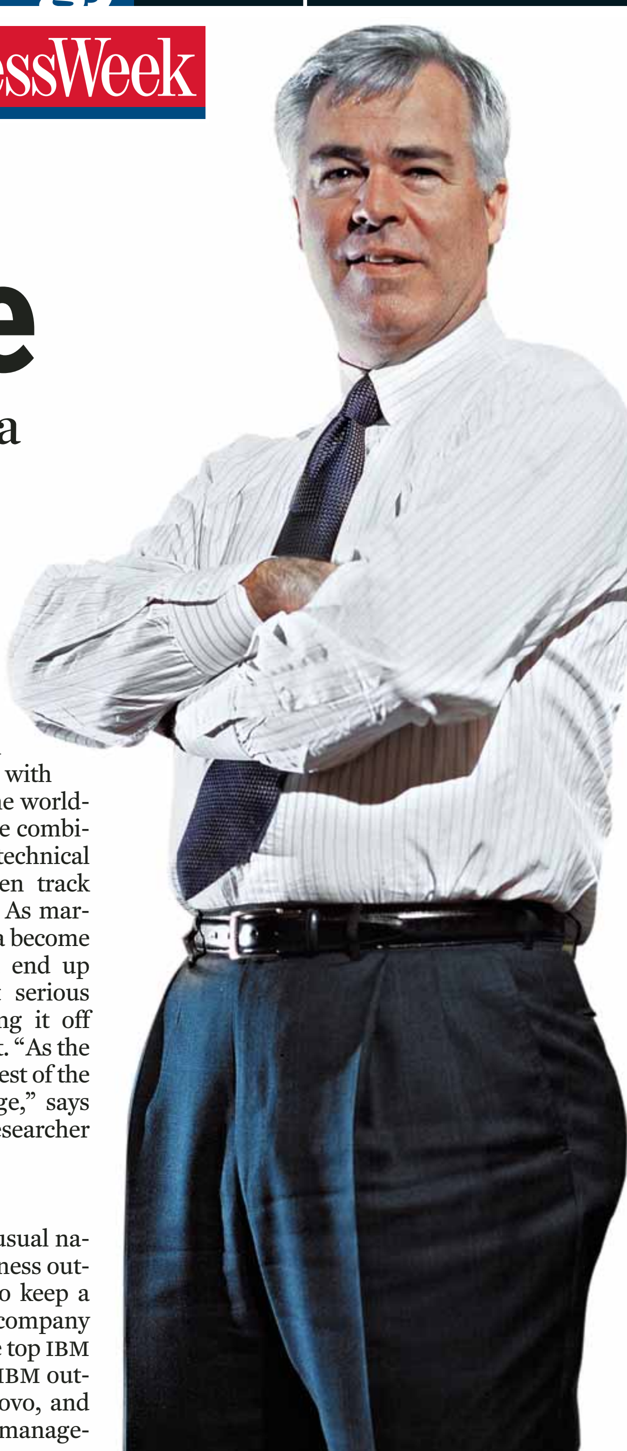
BusinessWeek

East Meets West, Big-Time

Lenovo's deal for IBM's PC unit led to a merger of talent—and a threat to Dell



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THE DATE WAS APR. 20, 2004. The setting: the offices of Legend Holdings Ltd. in Beijing. And the event was something akin to a courtroom trial, in which the proposed purchase of IBM's PC division by Legend subsidiary Lenovo Group Ltd. hung in the balance. The judge and jury—Legend's directors, including co-founder Liu Chuanzhi—had gathered in a windowless conference room on the 10th floor of company headquarters to grill Lenovo's execs and others about potential pitfalls.

The deal's advocates faced a barrage of questions. In addition to Mary Ma, Lenovo's chief financial officer, the lineup included people from consultant McKinsey and investment bank Goldman Sachs. The directors' chief concern: Were Lenovo's execs really capable of running a complex global business? The breakthrough came after three days. The directors concluded that if Lenovo could recruit IBM's top execs to help manage the company, this merger could succeed. "The board felt there were positive solutions," says Liu.

Watch out Michael Dell. What began in Beijing a year ago is expected to culminate with the closing of Lenovo's acquisition of the IBM PC division in early May. There are huge challenges ahead for Lenovo, and Dell Inc.'s dominance in the U.S. market isn't in danger. But the new Lenovo, with $13 billion in sales and 8% of the worldwide PC market, will boast a rare combination of management savvy, technical expertise, low costs, and proven track record in the developing world. As markets like China, India, and Russia become more important, Lenovo could end up presenting Dell with its most serious competition in years—by boxing it off where demand is growing fastest. "As the battle shifts from the U.S. to the rest of the world, Lenovo has the advantage," says analyst Martin Reynolds of researcher Gartner Inc.

THE ICON AND THE UPSTART

LENOVO'S STRENGTH is its unusual nature. Rather than sell its PC business outright, IBM ultimately decided to keep a 13.4% stake in the combined company and as Liu had hoped, contribute top IBM execs to help run it. In essence, IBM outsourced its PC business to Lenovo, and Lenovo outsourced much of its manage-

A Long Time Coming

IBM first approached China's Lenovo about selling its PC division in early 2002, but the talks went nowhere because the IBM unit was suffering deep losses. Only 18 months later, with the PC division recovering, did negotiations begin in earnest. A look at the lengthy courtship:

NOVEMBER, 2003: Lenovo CFO Mary Ma travels to New York to investigate the possibility of Lenovo buying IBM's PC unit, but Ma has been warned by her bosses that chances of a deal are remote. Nevertheless, she returns home convinced it's a smart move. She persuades the company to open talks two months later.

FEBRUARY, 2004: IBM CEO Sam Palmisano visits with Lenovo Chairman Liu Chuanzhi in Beijing. IBM brings in private equity firm Texas Pacific Group as a potential alternative bidder, giving it leverage in the negotiations.

APRIL, 2004: Lenovo's board of directors grills the company's execs about the deal. Among other things, they're concerned that Lenovo execs, such as CEO Yang Yuanqing, don't have the experience to run a global

ment and sales to IBM. As a result, the first major merger between an American company and a Chinese one is creating a true blend of East and West, of tech icon and industry upstart. The chief executive will be Stephen M. Ward Jr., the former head of IBM's PC operation. Yang Yuanqing, the former Lenovo CEO, will be the chairman. The 30-member executive staff is split down the middle. Headquarters will be near IBM's in New York.

The two companies complement each other neatly. Lenovo specializes in consumer PCs and low-cost manufacturing. It dominates the PC market in China, with a 26% share last year. IBM ranges worldwide and focuses on businesses. Its 30,000-person sales force and global network of 9,000 business partners will help sell Lenovo PCs. "They create a formidable force against the direct guys like Dell," says Kevin M. Murai, president of Ingram Micro Inc., the No. 1 tech-products distributor.

Of course, the tech industry is littered with companies that thought they had an edge on Dell, only to be driven into oblivion by its relentless efficiency. The Round Rock (Tex.) company has garnered 18.5% of the PC market and demonstrated that it's without peer in PCs. Hewlett-Packard Co., the second-largest player, has lost share in recent years, to 15.4%, and is only marginally profitable. Even IBM's PC division lost ground in the first quarter, with unit sales up just 2%, compared with 13% for Dell, according to researcher IDC. The new Lenovo "will be good for us," says Kevin B. Rollins, Dell's CEO. "We think a lot of IBM customers will want to come to us."

But Lenovo isn't planning to out-Dell Dell. What makes Dell so successful is the efficiency of its purely direct-sales approach and build-to-order manufacturing. Lenovo has a very different philosophy. It will sell through retailers, corporate resellers, the IBM sales force, and Dell's route as well. That presents a sizable opportunity, particularly in emerging markets. Worldwide, more than 80% of PCs are sold through retailers and other resellers. That figure is even higher in China and other developing countries, where consumers like to get their hands on products and frequently don't have credit cards.

Instead of a straight sale, IBM kept a stake to gain a foothold in China

PARTNERED CEO Steve Ward and incoming chair Yang Yuanqing

Not that Lenovo can't pinch pennies. Its labor costs are a rock-bottom $3 per desktop PC, among the lowest anywhere. That has helped drive its operating expenses to less than 9% of revenues, half the average for the computer hardware business and about the same as Dell's. Lenovo's expenses will rise as it combines with the higher-cost IBM division, but it doesn't have to overtake the big dogs to be a winner. It just needs to take market share, gain economies of scale, and grow profitably. Lenovo's track record is persuasive. In spite of tough competition from local rivals Tongfang and Founder, it upped its market share in China by four percentage points, to 28%, between the first and fourth quarters last year.

ADDED MUSCLE

THE NEW LENOVO has to work the same magic as it combines the two operations. Morgan Stanley projects a net profit of $221 million, on sales of $14 billion, in fiscal 2006. That's paltry compared with Dell's expected $4 billion in profits, on $57 billion in sales, for fiscal 2006. But Lenovo may be able to squeeze out even more costs. The company says publicly it expects to save more than $200 million a year in supply-chain efficiencies. Sources close to the deal say Lenovo could save

company. After three days of questioning, the board gives its approval to make an offer.

JUNE, 2004: IBM and Lenovo decide that rather than an outright sale, IBM will keep a stake in the combined PC company and resell Lenovo's PCs to its corporate clients.

NOVEMBER, 2004: Lenovo and Texas Pacific make final bids in late November. IBM chooses Lenovo because its $1.25 billion offer is slightly higher and because closer ties between the two companies could help IBM in the fast-growing China market. The Chinese opt to hire Steve Ward, head of IBM's PC business, as CEO of the new company.

DEC. 7, 2004: The deal is unveiled. Although Yang had initially proposed dual headquarters in Beijing and New York, Ward persuades him customers will react best if the entity is based solely in the U.S.

MAR. 9, 2005: A U.S. government review is drawn out by national security concerns. The investigation includes field trips to IBM's offices in Raleigh, N.C., to confirm that Lenovo and IBM's non-PC facilities will be kept separate. Ultimately, the government approves the deal.

EARLY MAY: The deal is expected to close, creating a $13 billion global PC company with 8% market share, third in the world behind Dell and Hewlett-Packard.

several hundred million yearly on top of that because the company will no longer have to pay IBM corporate expenses and may be able to get high-volume discounts from suppliers Microsoft Corp. and Intel Corp. "Potentially, there's a lot of money on the table," says a financier close to the deal.

With its added muscle, Lenovo fully intends to change the dynamics of the PC business. Rather than simply compete on price, the company plans to distinguish itself through innovation. The new company starts from a good spot. IBM's ThinkPad laptops have consistently beaten Dell to market with features such as a built-in fingerprint reader. Lenovo is no slouch either. One of its new PCs with easy-to-use Internet telephone service has won raves from reviewers. Declares Yang: "We will be the PC company with the best balance between innovation and efficiency."

HUMBLE ROOTS
Chairman Liu, next to Lenovo's birthplace

QUENTIN SHIH/ASIA IMAGES

The big test comes when the two organizations actually operate together. The culture gap is huge. For instance, the Chinese don't tolerate being tardy for meetings, while IBMers are often late. It's hard to predict when glitches will pop up. Last Dec. 20, when Yang, Ma, and eight other Lenovo execs landed at John F. Kennedy International Airport in New York for their first planning meetings, nobody met them. Not good: In China, visitors are greeted and taken to their hotels in limos. "We blew it," says Brad Hall, an IBM consultant working on the transition. "Yuanqing brought it up at a meeting, and Steve said, 'We'll fix that.'"

Over the five months since the deal was announced, execs from both sides have been working feverishly to get off to a fast start. Initially, to avoid disruptions, they will operate three separate business units—China PCs, China cell phones, and international operations, which were formerly IBM's. But they plan to quickly integrate supply-chain operations. Ward plans to expand consumer sales into four countries beyond China this year—though he won't name them yet. He plans a marketing blitz to turn Lenovo into a global brand culminating with sponsorships of the 2006 and 2008 Olympics. And he's partnering with Intel, Microsoft, and others on PC innovation centers in Beijing and Raleigh, N.C. "The PC is ubiquitous, but purely being a commodity isn't good enough," says Ward, 50.

Ward plans a marketing blitz that includes two Olympic sponsorships

This long, strange saga started with an act of quiet desperation. In the summer of 2002, IBM's then-chief financial officer, John R. Joyce, hit China in hopes of selling the company's struggling PC business to Legend, which later changed its name to Lenovo. But IBM's once-proud PC unit had lost nearly $400 million the previous year. Legend execs turned up their noses.

Eighteen months later, it was a different story. Joyce returned to China and Lenovo was hungry to become a global player in the PC business. Then CFO Ma took her first trip to New York to talk things over with IBM negotiator Peter Lynt. Liu had cautioned her not to fall in love with the deal, but Ma saw that IBM had radically restructured the PC unit. Costs had been slashed. Manufacturing for everything but the laptop line had been outsourced. "We were astonished to see the better numbers," says Ma. She returned to China an advocate for the deal.

BREAKTHROUGHS

STILL, IBM wasn't taking any chances. It sought out private equity giant Texas Pacific Group as an alternative bidder and the rival to put pressure on Lenovo. "Peter would use the other bidder against us," recalls Ma. "He said, 'If you don't do that price, you're out.'"

But Lenovo was in. Ma's enthusiasm helped win over her board. A second breakthrough came last summer during a week of top-secret talks at the luxurious Siena Hotel in Chapel Hill, N.C. After a series of meetings, Yang and IBM CEO Samuel J. "Sam" Palmisano agreed this would be more than just a simple sale of assets. Instead, the two companies would form a strategic alliance.

While the general idea had been floating around for months, the two companies nailed down the details to make a long-term partnership compelling for both sides. IBM would sell Lenovo PCs through its sales force and distribution network. IBM also would provide services and financing for Lenovo PCs—and allow Lenovo to use the vaunted IBM brand name for five years. In turn, Lenovo, which is still partly owned by the government's Chinese Academy of Sciences, would help IBM gain entrée into the promising China market.

IBM ended up with two options for its PC division. At a board meeting on Oct. 26, Ward and IBM CFO Mark Loughridge laid out the offers from both Lenovo and Texas Pacific. They were attractive enough that directors O.K.'d a deal with either one. Ultimately, on the first weekend in December, Palmisano accepted Lenovo's bid. The offer was higher, at $1.25 billion, and the help in China was a substantial sweetener. Even Texas Pacific saw the logic behind Palmisano's deci-

sion. The company, along with private equity players General Atlantic and Newbridge Capital, later invested $350 million in Lenovo.

Since the deal was announced, both Lenovo and IBM have been working hard to make sure it will be a success. They've tried to be open to each other's cultures. Yang declared English Lenovo's official language. Liu tapped Ward as Lenovo's CEO, a position Ward considers a big honor. He recalls listening to news of Nixon's historic visit to China on the radio when he was a 17-year-old pumping gas at his father's Exxon station in Santa Maria, Calif. "If you had told me then that I would lead the first-ever merger of a Chinese company and an American company, I would have been stunned," Ward says.

Making history is messy, however. When Ward and Yang met for lunch at IBM's Madison Avenue offices for a get-to-know-you session, Yang said that he favored dual headquarters, in the U.S. and China. It was a point of national pride. Ward disagreed, saying there should be a single one, in New York. They couldn't resolve the issue over lunch. But a couple of days later, Yang came around. "Steve made a lot of sense," he says. "Putting the headquarters in New York tells our global customers that we're a global company."

Now, Lenovo execs are busy moving into the fourth floor of a small office building five miles from IBM headquarters. Seventy people will work there, including Ward, Yang, and Ma.

Meanwhile, back in Beijing, Liu is preparing to give up command of the company he has led for 21 years. It's a big change for someone who started the company with $24,000 in a two-room cottage near "Swindler's Alley," Beijing's electronics black market, and built it into one of China's most respected businesses. "I am quite satisfied with what I have accomplished so far," he says. "So now I'm stepping back and letting a younger generation lead."

As Liu bows out, a new era dawns for Lenovo. And really, for the whole business world. If China is to make the leap from low-cost producer to global economic giant, it will be nervy outfits like Lenovo that lead the charge. Goodbye Swindler's Alley, hello world.

–With Dexter Roberts in Beijing and Louise Lee in Austin, Tex.

BusinessWeek online For more on how Lenovo and IBM people are working together, see www.businessweek.com/extras